Supreme Court, U.S.
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No. _____

IN THE SUPREME COURT OF THE UNITED STATES

Glenn Hightower,

Petitioner,

v.

Commissioner of Internal Revenue

Respondent.

On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the Ninth Circuit

PETITION FOR A WRIT OF CERTIORARI

Glenn Hightower
Pro se
c/o APh Technological Consulting
2500 E. Colorado Bl., Suite 300
Pasadena, California 91107
(626) 796-0331

QUESTIONS PRESENTED

1. In 1998 Congress enacted section 7491(a) to the Internal Revenue Code, which provides that if a taxpayer introduces credible evidence with respect to a factual issue in a tax issue, the government shall have the burden of proof with respect to that issue. The Tax Court has adopted a practice of refusing to follow the statute in cases where taxpayers don't explicitly contend it applies. Is this correct?

2. The "claim of right" doctrine provides that a payment constitutes income if received under a claim of right and without restriction to its disposition. Under that doctrine, is Petitioner liable for tax on a $41 million payment tendered to him where (a) Petitioner at all times disclaimed any right to the tender, (b) the tender was illegal under state corporation law, (c) Petitioner's voluntary participation in the transaction would have constituted a misdemeanor, (d) Petitioner was compelled to take the tender under threat of financial loss, (e) Petitioner held the tender in a segregated account and (f) Petitioner brought legal action to compel its return?

3. Is Petitioner liable for tax on the $4.2 million distributive share of income attributed to stock in a subchapter S corporation where he was owner of record but substantially all benefits and risks of stock ownership flowed to a third party?

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IN THE SUPREME COURT OF THE UNITED STATES

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v.

Commissioner of Internal Revenue, Respondent

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Glenn Hightower respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth District in this case.

OPINIONS BELOW

The opinion of the Tax Court is *Hightower v. Commissioner*, T. C. Memo 2005-274, hereinafter referred to as *Hightower*. The opinion of the Court of Appeals is *Hightower v. Commissioner*, 266 Fed. Appx. 646 (9th Circuit, 2008).

JURISDICTION

The judgment of the Court of Appeals was filed on February 12, 2008. The order of the Court of Appeals denying Petitioner's Petition for Rehearing En Banc was filed April 28, 2008. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

RELEVANT STATUTES

Internal Revenue Code 26 USCS §7491(a).

> (1) General rule. If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.

STATEMENT OF FACTS[1]

A. Green Hills Software, Inc.

1. Formation and Management

Daniel O'Dowd ("O'Dowd") and Petitioner were 50-50 owners of Green Hills Software, Inc. ("Green Hills"). Petitioner was chairman of the board and secretary, and O'Dowd was president and treasurer. Petitioner and O'Dowd were Green Hills' only directors. Green Hills was at all relevant times an S corporation for Federal income tax purposes. (ER-22 3, ER-13 26.)

Green Hills was a statutory close corporation subject to the laws of both California and Delaware. (ER-9.6 2, ER-9 ¶8, ER-13 26.) Under applicable state corporation law, close corporations may be governed by a shareholders' agreement. (Cal. Corp. Code §300(b); 8 Del. C. §350, §354.) Petitioner and O'Dowd entered into such an agreement, which provided that (1) any dispute between them would be resolved through binding arbitration (2) that either of them could initiate a buy/sell of the stock held by the other at a [minimum[2]] price determined by a formula and (3) that the corporation was required to make a quarterly distribution in the amount of 75% of its net income. (ER-22 3, ER-9.4 5, ER-9.4 2, ER-9

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[1] Citations to ER are to the Excerpts of Record before the Court of Appeals.

[2] The Trial Court found that the formula determined a price, rather than a *minimum* price, a clear error.

¶6.) The corporation's bylaws provided that directors had the absolute right to inspect the corporation's books, records, documents and physical properties. (ER-9.7 6, ER-9 ¶9, ER-13 34.)

Prior to 1998, Petitioner had full and unhindered access to the premises of the company, access to all records and could speak with any employee. He had a master key to the company's headquarters, the "super-user" password to its computer network and a network connection to the computer network from his own office. Prior to 1998, Petitioner and O'Dowd managed the business of the company informally in personal and telephonic encounters; when formal resolutions were required, they usually done by unanimous written consent. The parties did hold formal annual meetings of the shareholders and directors, but these were pro forma meetings lasting only a few minutes. (ER-13 35.)

2. O'Dowd triggers buy/sell

In late 1997, O'Dowd told the company's vice presidents that he intended to buy out Petitioner, and asked for and received commitments from them to support him. In January 1998 O'Dowd announced his intention at a company-wide meeting, at which he told Green Hills' employees he intended to purchase Petitioner's shares at ten times earnings, that the market value was significantly greater than that and that he would sell Petitioner's shares to the company at his cost, thereby approximately doubling the value of their stock options. O'Dowd also made statements intended to place Petitioner in a poor

light and encourage support for O'Dowd's buyout. (ER-13 36; ER-9.21 5-6, ER-9 ¶63; ER-9.46 3-4, ER-9 ¶63.)

Petitioner went to Green Hills' headquarters on March 15, 1998. O'Dowd demanded that Petitioner leave and threatened to call the police if Petitioner refused. On March 25, 1998, O'Dowd notified Petitioner that his access to the company was denied, that the locks had been changed, and that his employment and access to the computer system had been terminated. (ER-22 4.) Petitioner thereupon asked that the board of directors meet monthly; O'Dowd replied with a letter stating that such meetings were not necessary. (ER-13 38.)

In a letter dated June 26, 1998, O'Dowd triggered the buy/sell provision of the shareholders' agreement by offering either to sell his shares to Petitioner for $47 million or to buy Petitioner's shares for $47 million. Petitioner did not want to sell his stock, but rather wanted to exercise his right under the shareholder's agreement to buy O'Dowd's stock for the amount O'Dowd had offered for Petitioner's stock. (ER-22 4-5.)

Petitioner interested an investor, Safeguard Scientifics, in financing his purchase of O'Dowd's shares, but when its representatives visited Green Hills to do due diligence they were told that the vice presidents and many other employees would resign if Petitioner purchased O'Dowd's shares. Safeguard was subsequently sent a letter signed by 60 employees, including the vice-presidents and most of

the senior management, suggesting that financing Petitioner's buyout was ill-advised. As a result, Safeguard felt unable to proceed. (ER-13 38-39; ER-9.21 6, ER-9 ¶63; ER-9.46 4, ER-9 ¶63.)

On August 24, 1998, pursuant to the arbitration clause of the shareholders' agreement, Petitioner demanded arbitration regarding O'Dowd's buyout. (ER-22 5.) Petitioner alleged O'Dowd violated his fiduciary duty and obligation of good faith and fair dealing by involving the employees in his buyout effort to Petitioner's disadvantage. (ER-13 39.)

3. Petitioner improperly denied participation in management

On October 22, 1998, Petitioner again sought to regain his role in participating in the management of the company. He wrote O'Dowd a letter requesting monthly board meetings at which the board would receive "a comprehensive report on the state of the business from you and short reports from each of the vice presidents." The letter included a formal notice for a board meeting. (ER-9.12, ER-9 ¶14, ER-13 41.) O'Dowd responded with a letter stating there was no specific reason to hold a board meeting and refusing to attend the meeting noticed by Petitioner. (ER-9.13, ER-9 ¶15, ER-13 42)

B. Arbitration

1. O'Dowd's financing would have left the company with a negative net worth

Evidence developed during the course of the arbitration established that O'Dowd's buyout plan

called for Petitioner's shares to be sold to Green Hills in a transaction that would have left Green Hills with a negative net worth of approximately $20,000,000. (ER-13 42-43.)

2. Proposed interim award

On December 1, 1999, the arbitrator issued the December 1999 award finding that O'Dowd had not acted improperly in his attempt to buy Petitioner's shares. The award stated that the arbitrator would reassess the award after considering motions for reconsideration and entry of partial final award. (ER-22 5, ER-9.20.)

O'Dowd refused to permit Green Hills to pay Petitioner any further dividends at any time after the issuance of the December 1999 award. (ER-13 46.) Specifically, Petitioner received no dividends in 2000. (ER-22 4.)

3. Partial final award

The arbitrator issued a partial final award on March 8, 2000. (ER-22 5.) The award stated that its intent was to give O'Dowd the benefits of the transaction as if it had occurred in 1998:

> Because [O'Dowd] was entitled to complete the purchase of [Petitioner]'s shares on September 24, 1998, a remedy must be fashioned that gives [O'Dowd] the benefit of his bargain under the Shareholders Agreement. ... The intent of this award is to provide [O'Dowd] with the benefit of the prior

> deal as closely as that may now be approximated.

(ER-9.21 16-17, ER-9 ¶23) The Tax Court found that the award permitted O'Dowd to treat the purchase of Petitioner's stock as having occurred on September 24, 1998, 90 days after O'Dowd invoked the buyout provision of the shareholders' agreement. (ER-22 5.)

The arbitrator made the following findings: (a) but for Petitioner's failure to tender his shares to O'Dowd within 90 days of O'Dowd's deposit of $47 million with Green Hills, his legal or beneficial interest in Green Hills would have terminated on September 24, 1998; (b) O'Dowd has the right but not the obligation to pay or cause Green Hills to pay Petitioner for the shares ($47 million) [within six months[3]]; (c) the purchase price shall be reduced by dividends and salary (net after payment of taxes) paid to Petitioner for the period after September 24, 1998; and (d) until O'Dowd completes the purchase of Petitioner's stock, Petitioner shall be paid all dividends in accordance with the shareholders' agreement, which payments shall offset the purchase price for the shares. (ER-22 5-6, ER-9.21 17.)

The Award also provided that the purchase price be reduced by O'Dowd's costs in raising replacement financing, up to $1.277 million:

> Respondent shall be entitled to recover from [Petitioner] any costs connected with the

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[3] The Tax Court characterized this as "by September 24, 1998," a clear error.

> financing of the purchase of [Petitioner]'s shares as contemplated by the Partial Final Award, but not to exceed the sum of $1,276,843.07. The arbitrator reserves jurisdiction to determine the extent to which such costs shall constitute an offset to the purchase price on the basis that they are comparable to the costs previously incurred in connection with the September 26, 1998 offer to purchase transaction.

(*Id.* 18.)

The award also provided that the arbitrator could make other adjustments to the purchase price. (*Id.*)

As to Petitioner's claim for access, the arbitrator declined to provide relief on the grounds that O'Dowd would first be given the opportunity to acquire Petitioner's shares. (*Id.* 15.)

4. Corrected partial final award

O'Dowd subsequently requested that the arbitrator correct the award to include a procedure for the exchange of shares, and proposed terms for such a procedure. The arbitrator issued a corrected partial final award on April 25, 2000, which incorporated O'Dowd's proposed terms:

> 6. ... Tender shall be made by [O'Dowd] or his agent presenting a check or checks aggregating the full amount of the purchase price made payable to [Petitioner] drawn on good funds in United States banks at the

offices of counsel for [Petitioner] during regular business hours and after giving at least two hours telephonic or fax notice thereof.

7. Simultaneously with and in exchange for the tender, [Petitioner] or his agent shall deliver to [O'Dowd] all of [Petitioner]'s share certificates in Green Hills with properly endorsed stock powers ("Shares").

8. In the event [Petitioner] does not deliver his Shares to [O'Dowd] simultaneously with the tender, [O'Dowd] shall hold the check or checks for the purchase price for delivery to [Petitioner] in exchange for the Shares for five days. During such time, the exchange may be made by [Petitioner] or his agent presenting the Shares at the offices of Green Hills or such other location as [O'Dowd] may designate in writing, during business hours and after giving at least 12 hours telephonic or fax notice thereof.

9. In the event the exchange does not take place within the foregoing five days, [O'Dowd] may release the funds for the purchase price, and the amount and procedures for any payment to [Petitioner] for the Shares shall be determined by the arbitrator, who reserves jurisdiction for such purpose.

(ER-9.22 18, ER-9 ¶24, ER-13 50-51.) The award also provided that:

> The purchase price shall be offset and reduced by all dividends paid to [Petitioner] based on Green Hills' earnings for the Third Quarter of 1998 and thereafter until the date of purchase of [Petitioner's] share; said offset shall be reduced by the amount of ordinary taxable income of Green Hills (excluding long term capital gains) attributable to [Petitioner] for the period September 24, 1998 until the purchase date multiplied by a fraction the numerator of which is .1367 and the denominator of which is .7070.

(ER-22 6.) The purpose of this paragraph was apparently to ensure that Petitioner would not bear the tax consequences of his continued record ownership.

Petitioner filed a petition in the California Superior Court for the County of Los Angeles (the Superior Court) and a petition for writ of mandate in the Court of Appeal of the State of California for the Second District (the California Court of Appeal) in an effort to have the partial final award vacated. (ER-22 6.)

C. The purported stock purchase

1. Adjusted purchase price

Green Hills hired an accountant to compute the adjusted purchase price pursuant to the corrected partial final award. The accountant

estimated the adjusted total purchase price for Petitioner's shares to be $42,862,230.95 as of October 15, 2000. (ER-22 7.)

2. O'Dowd tenders payment

On October 13, 2000, while the writ petition was pending, Frank Merideth, an attorney representing both O'Dowd and Green Hills, called Petitioner's attorney and advised him that he would appear at the offices of Petitioner's attorney with the purchase price for Petitioner's shares.[4] Upon arrival he first presented Petitioner's attorney with a letter stating that "Concurrently with the hand delivery of this letter," Merideth was tendering two checks totaling $41,585,388. The letter also requested delivery of Petitioner's share certificates. There was nothing in the letter indicating whether O'Dowd was buying the shares personally or whether he was exercising his right to cause Green Hills to make the purchase, as permitted by the Partial Final Award. (ER-9 ¶28; ER-9.23, ER-9 ¶26; ER-13 53-54; ER-9.43 2-3, ER-9 ¶60, ER-13 75-76.)

Based on his personal knowledge of O'Dowd, the fact that O'Dowd had asked the arbitrator to provide that Green Hills could purchase Petitioner's shares directly and the fact that O'Dowd's original transaction would have left the company with a negative net worth, Petitioner had strong reason to believe, and did believe, that O'Dowd was causing

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[4] The trial court's discussion does not distinguish when parties were acting personally or through attorneys, or when O'Dowd was acting for himself or for Green Hills.

Green Hills to purchase the shares, and that the transaction would leave the Green Hills with a negative net worth. (ER-13 54; ER-9.43 3, ER-9 ¶60, ER-13 75-76.)

Petitioner was aware that for Green Hills' to purchase Petitioner's shares in a transaction that left the company with a negative net worth would violate both California and Delaware corporation law (Cal. Corp. Code §166, §500, 8 Del. C. §160(a)) and that the individuals authorizing the transaction would be committing a misdemeanor. (Cal. Corp. Code §2253.) Petitioner also understood that since the arbitrator's power derived from the agreement to arbitrate, which in this case was the shareholders' agreement, it ultimately flowed from the shareholders themselves, and that as a result the shareholders bore the ultimate liability for any remedy ordered by the arbitrator. (ER-13 54-55; ER-9.43 3, ER-9 ¶60, ER-13 75-76.)

Petitioner was also aware that, under California law, he could not accept the tendered funds without losing his right of appeal. (ER-13 55.)

Petitioner was also aware of the provisions in the award providing that if "the exchange" did not take place, O'Dowd could "release the funds for the purchase price" and the "amount and procedures for any payment to [Petitioner] shall be determined by the arbitrator." (ER-9.22 18), Following the logic used elsewhere in the award (ER-9.21 17-18) and set forth above, refusal to participate in the exchange

could cost Petitioner another $1.277 million. (ER-13 55-56; ER-9.43.)

Petitioner was also aware that was also a small but non-zero risk that if he refused to participate in the exchange he could lose the entire amount. Under California law, the Court may under some circumstances correct an unlawful award by removing the offending provisions. (Cal. Code. Civ. Proc. §1286.6.) If the Court were to simply correct the award to strip the arbitrator of his continuing jurisdiction, the result could be that O'Dowd would receive Petitioner's shares with no compensation whatever to Petitioner. (ER-13 56; ER-9.43 2.)

Petitioner's attorney tried to deliver the share certificates without taking custody of the checks, but Green Hills' attorney insisted on delivering the checks. Accordingly, prior to accepting custody of those checks, Petitioner's counsel provided that attorney with a letter stating that "we are handing you herewith" Petitioner's share certificates and that "We do so under protest, and under compulsion of the Partial Final Award, and your invocation of it only, and without waiver of any rights or remedies of [Petitioner]." [5] (ER-9.24.) The letter went on to say that (a) Petitioner's participation in the transaction was not voluntary, (b) Petitioner was not entitled to the check, (c) the money still belonged to

[5] The Tax Court characterized the letter as saying "[Appellant] would *tender* his shares of Green Hills to O'Dowd under protest, and without waiver of any rights or remedies ..." (ER-22 8, emphasis added.) To the extent "tender" means something other than "handing," that characterization is a clear error.

O'Dowd/Green Hills, and (d) O'Dowd/Green Hills were to hold Petitioner's shares in trust:

> [Petitioner] does not voluntarily acquiesce in or recognize the validity of the arbitrator's award. He takes the position that he is not entitled to the check you have delivered into his custody, that the money still belongs to Mr. O'Dowd or Green Hills as the case may be, that Mr. O'Dowd or Green Hills is not entitled to [Petitioner]'s shares, and that Mr. O'Dowd or Green Hills will be holding such shares in trust for [Petitioner].

(ER-9.24, ER-9 ¶27, ER-22 8.) Both Green Hills' attorney and O'Dowd reviewed the letter thoroughly, but nevertheless insisted on proceeding. (ER-9.49 18, ER-9 ¶66; ER-13 6.)

Green Hills' attorney then delivered to Petitioner's attorney two checks dated October 23, 2000 in the amounts of $32,585,388 and $9 million. (ER-22 7.) Petitioner's attorney handed over Petitioner's stock certificates. (ER-9.49 18.) Petitioner had not endorsed the certificates. (ER-22 8.)

The checks tendered by Green Hills' attorney were temporary checks bearing no indication as to whether they were drawn on accounts belonging to the company or to O'Dowd personally; so it was impossible to tell from the checks whether O'Dowd was purchasing the shares personally or exercising his right to cause the company to purchase the

shares. (ER-9.27, ER-9.28, ER-9 ¶¶33-34, ER-13 58-59.)

O'Dowd drafted a receipt for the checks that read in pertinent part: "Receipt of [checks] aggregating $41,585,388 as payment for all of the shares of [Petitioner] in Green Hills Software, Inc. is hereby acknowledged." Petitioner's attorney crossed out the phrase "as payment for all of the shares of [Petitioner] in Green Hills Software, Inc." and signed the receipt. The face and endorsement areas of each check indicated that the check was not valid if presented for payment after October 23, 2000. Petitioner deposited the checks in an interest-bearing bank account that Petitioner had opened solely to hold the funds. (ER-22 7-8.)

Interest was credited to the segregated account in the amounts of $469,593.63 in 2000 and $1,513,788.28 in 2001. There were no transactions on the account in 2000 or 2001 other than the crediting of interest and withholding of Federal income tax. (ER-22 8.)

D. O'Dowd's motion to dismiss the writ petition

On 30 October 2000, O'Dowd filed a motion to dismiss Petitioner's writ petition on the grounds that by accepting the tender, Petitioner had waived his right to contest the arbitration award. (ER-9.37, ER-9 ¶54.) O'Dowd told the Court, "Were this Court to vacate the award on this petition or on a subsequent appeal, [Petitioner] would no longer be entitled to the

purchase price. [Petitioner] has accepted the benefit of the buyout that was contingent upon the Partial Award being upheld." (ER-9.37 5.) Petitioner opposed the motion on the grounds that there was no acceptance because Petitioner acted under the threat of financial loss and had explicitly disclaimed any right to the money prior to taking custody of the checks. (ER-9.38, ER-9 ¶55.)

On 21 November 2000, O'Dowd's attorney sent Petitioner's attorney a letter inviting Petitioner to wire the tender to his firm's trust account. The letter stated "We will hold the funds *in trust for [Petitioner] subject to his directions.*" (Emphasis added.) This was another trap: had Petitioner done as suggested, he would have conceded the funds were being held for his benefit rather than for Green Hills'. (ER-9.32, ER-9 ¶39, ER-13 65.)

Subsequent to transmission of the above letter, O'Dowds' attorney remarked to Petitioner's attorney that he hadn't seen Petitioner's wire show up in his trust account. In response, Petitioner's attorney offered to return the money to the company, which offer was not accepted. (ER-13 65, 67)

The Court of Appeal subsequently issued an opinion which denied O'Dowd's motion to dismiss. (ER-9.39 38, ER-9 ¶56; ER-9.36; ER-9 ¶52.)

E. Investigation confirms the purported transaction was illegal

Petitioner immediately raised the probable violations of the California and Delaware Law in

ongoing proceedings before the arbitrator. In response to a document request, Petitioner on December 13, 2000, received several documents from Green Hills. The documents included financial statements for the period immediately before and after the purported purchase of Petitioner's shares. The balance sheet as of September 30, 2000 shows the company with a positive net worth (shareholder's equity) of $27, 245,426 (ER-9.56 6, ER-9 ¶75), the balance sheet as of October 31, 2000 shows a negative net worth of ($13,460,463). (ER-9.57 11, ER-9 ¶76.) These documents verified Petitioner's suspicion that the purported purchase would leave the company with a negative net worth. (ER-13 69-71.)

The documents included a declaration from a vice president of Imperial Bank that the checks presented on October 13, 2000, were drawn on the accounts of Green Hills, establishing that it was the company that was purchasing the shares. (ER-9.25, ER-9 ¶29, ER-13 71.)

The documents also included a fax sent by O'Dowd that states, "This structure substantially improves the company's balance sheet... It reduces the negative net worth of the company by 15%." The attached "projected closing balance sheet" shows two financing options, which leave the Company with a negative net worth (stockholders' equity) of $18 million and $15 million, respectively. These documents established that O'Dowd was well aware his financing would leave the company with a

negative net worth. (ER-9.55 3-4, ER-9 ¶74; ER-13 71-72.)

F. Petitioner seeks to have the arbitrator declare the transaction invalid

Petitioner submitted the evidence of illegality to the arbitrator. (ER-9.42 6, ER-9 ¶59, ER-13 9-11.) On 4 September, 2001, the arbitrator issued a Final Award. With respect to Petitioner's request to have the transaction declared void on the grounds it was illegal, the arbitrator "assumed for the purposes of this discussion" that Petitioner's calculations of Green Hills solvency were correct, but concluded that "[Petitioner] has no standing to assert this claim, as he is not a non-consenting creditor." (ER-9.42 6, ER-9 ¶59.) O'Dowd, for his part, sought a ruling that the transaction was valid (ER-9.52 10, ER-9 ¶69), and in that regard the arbitrator found that O'Dowd's purchase of Petitioner's stock complied with the partial final award and terminated Petitioner's interest in Green Hills and that the payment belonged to Petitioner without restriction. (ER-22 9.) The Arbitrator also reduced the purchase price by the net amount of $551,322.30 and required Petitioner to refund that amount. (ER-9.42.13.)

G. Petitioner seeks to vacate arbitration award

O'Dowd and Petitioner filed cross petitions to confirm and vacate the Final Award. Petitioner contended that the Final Award (1) improperly authorized a transaction that was illegal under

California and Delaware law and (2) improperly awarded O'Dowd damages resulting from a preliminary injunction. (ER-9.46 14. ER-9 ¶63.)

The Superior Court confirmed the arbitration award. Petitioner appealed the Superior Court's decision. (ER-22 9.)

H. O'Dowd moves to dismiss Petitioner's appeal

On November 15, 2002, O'Dowd filed a motion to dismiss Petitioner's appeal on the grounds that Petitioner forfeited his right to appeal by accepting the benefits of the transaction. (ER-9.48, ER-9 ¶65.) Petitioner opposed the motion on the grounds that there was no acceptance because Petitioner acted under duress and had explicitly disclaimed any right to the money prior to taking custody of the checks. (ER-9.49, ER-9 ¶66.)

On 10 December 2002, the Court of Appeal explicitly denied O'Dowd's motion to dismiss the appeal, subject to being revisited at oral argument. (ER-9.45 2, ER-9 ¶62.) The matter was not revisited at oral argument, and the appeal was decided on the merits. (ER-9.45 3, ER-9 ¶62; ER-9.52, ER-9 ¶69; ER-13 78.)

I. Petitioner's appeal is denied

On 31 July 2003, the Court of Appeal, declaring its standard of review to be "we must review the trial court's judgment confirming the arbitration award de novo, but must accept the factual findings and legal reasoning of the arbitrator, even if erroneous,"

denied the appeal in an unpublished opinion. By taking this approach and ignoring Petitioner's contention that the court must review all relevant facts and law when a violation of public policy is alleged, the Court of Appeal did not reach the question as to whether or not the transaction was legal. (ER-9.52 21, ER-9 ¶69.)

Petitioner's petition for review in the Supreme Court of California was denied on October 22, 2003. No other actions concerning the validity of the buyout were pending on the date of trial. (ER-22 9-10.)

J. Petitioner's distributive share of income from Green Hills, and tax returns for 2000 and 2001

Green Hills reported $4,275,909 as Petitioner's distributive share of income through October 13, 2000. (ER-22 10.)

Petitioner filed Federal income tax returns for 2000 and 2001. Petitioner did not include a distributive share of income from Green Hills on his 2000 return on the grounds that after December 1999, all benefits and liabilities of stock ownership flowed to O'Dowd. Petitioner did not include in income on his 2000 and 2001 returns the $41,585,388 tendered payment or any of the interest credited to the account in which he had deposited that payment on the reasoning that he disclaimed right to the tendered payment. (ER-22 10.)

K. IRS determines deficiency

After auditing Petitioner's returns for tax years 2000 and 2001, the IRS issued notices of deficiency based on the premises that (1) under the terms of the award, ownership of the shares didn't transfer until October 13, 2000, so the distributive share of Green Hills' income before that date was taxable to Petitioner, and (2) the $41 million payment, less Petitioner's basis, was taxable income under the claim of right doctrine.

L. The Tax Court and Court of Appeals affirm the IRS determination

Petitioner petitioned the Tax Court for review. The Tax Court affirmed the IRS determination. *Hightower v. Commissioner*, T.C. Memo 2005-274. The decision of the Tax Court was affirmed by the Court of Appeals. *Hightower v. Commissioner*, 266 Fed. Appx. 646 (2008).

ARGUMENT

I. The Tax Court Is Subverting the Intent of Congress by Refusing to Apply a 1998 Statute Shifting the Burden of Proof to the Commissioner; a Situation That Calls For This Court to Exercise Its Supervisory Power.

Prior to 1998, judicially created law held that the Commissioner's determination of tax liability was presumptively correct and the taxpayer bore the burden of disproving it. *Welch v. Helvering*, 290 U.S. 11, 115 (1933). In 1998 Congress changed this by enacting a new section 7491(a) of the Internal Revenue Code, which reads in relevant part as follows:

> (1) General rule. If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.

26 USCS §7491(a). Congress explained it was making the change because prior law put individual and small business taxpayers at an unreasonable disadvantage when forced to litigate with the Internal Revenue Service. Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998* (JCS-6-98), 56, *attached as Appendix C*. Congress further explained that, all

other things being equal, facts asserted by individual and small business taxpayers who satisfy relevant substantiation requirements should be accepted, and that shifting the burden of proof to the Secretary would create a better balance between the IRS and such taxpayers without encouraging tax avoidance. *Id.* The new rule applies to cases where the examination began after enactment. *Id., 58.*

In an early case, the Tax Court declined to apply the new section where it could not determine from the record whether the examination began before or after the statute's enactment and the taxpayer did not assert that it applied. *Whitehead v. Commissioner*, T.C. Memo 2001-317 (2001). In a later case involving a 1997 return, the Tax Court observed that the examination probably began after the enactment and if so, the burden would have been on the Commissioner (but then said its decision didn't depend on the burden of proof). *Anderson v. Commissioner*, 123 T.C. 219, 222-223 (2004). However, more recently the Tax Court has settled on a pattern of refusing to apply section 7491(a)(1) at all unless the taxpayer explicitly contends that it applies. *King v. Commissioner*, T.C. Memo 2006-112 (2006), *Storer v. Commissioner*, T.C. Summary Opinion 2007-56 (2007).

The Tax Court's approach is outrageous. There is nothing in the language of the section that suggests its benefits were to be available only to those who explicitly claim them; to the contrary, the section

explicitly declares itself to be the "General rule."[6] By requiring a taxpayer to contend that the section applies in order to enjoy its benefits, the Tax Court has created a trap crafted to deny those benefits to the very "individual and small business taxpayers" that the Congress sought to protect, namely taxpayers represented by their everyday counsel (as opposed to tax litigation specialists) or appearing *pro se*.

This is a case in point. Section 7491 came to Petitioner's attention while reading *U.S. Tax Court Rules of Practice and Procedure* in preparation for trial (specifically, Rule 142(a)(2)). In reliance thereon, Petitioner took care to present credible evidence in the form of stipulations, documentation and testimonial evidence. Upon receiving the Tax Court's opinion, he was stunned to find that the Tax Court ruled that because "Petitioner does not contend that Section 7491 applies ... Petitioner bears the burden of proof." *Hightower*, 12. When Petitioner raised the issue before the Court of Appeal, Respondent's answer did not dispute Petitioner's contention that the Tax Court had applied the burden of proof to the wrong party. The Court of Appeal ignored the issue in its decision.

Is the Tax Court justified in refusing to apply section 7491(a)(1) unless the taxpayer explicitly contends that it applies? Petitioner recognizes that

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[6] The next subparagraph of the statute sets forth as "Limitations" on the "General rule." There was no allegation here that any of these limitations applied.

this Court's resources are limited, but this question deserves an answer, and sooner rather than later, because it affects almost every taxpayer appearing before the Tax Court. It is clearly a question that calls for an exercise of this Court's supervisory power pursuant to *Rules of the Supreme Court of the United States,* Rule 10(a). If the Court cannot find time to address the question itself, it should at the very minimum remand to the Court of Appeal with instruction to address the question in a reasoned opinion.

II. This Court Has Inadvertently Created Two Competing, Inconsistent Statements of the Claim of Right Doctrine, and Is the Only Forum Able to Resolve the Conflict.

This Court established what has become known as the "claim of right doctrine" in the seminal case of *North American Oil Consol. v. Burnett,* 286 U.S. 417 (1932). There a taxpayer claimed a right to a payment, received the payment in one year, and defended against an action which eventually forced the return of the payment in a later year. The Court ruled that the payment was taxable in the year received, even though it was received under a cloud:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

Id., 424. The doctrine arises from the need for a practical tax accounting system:

> Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made, and would

violate the spirit of the annual accounting system.

Healy v. Commissioner, 345 U.S. 278, 284-285 (1953).

In 1961, this Court inadvertently created a competing and inconsistent statement of the claim of right doctrine. Here is a brief history of how this came about.

In *Commissioner v. Wilcox*, 327 U.S. 404 (1946) this Court considered the taxability of embezzled funds. The Court concluded that embezzled monies weren't taxable because the embezzler couldn't claim a right to those monies. *Id. 408*, citing *North American Oil*.

In *Sohio Corp. v. Commissioner* 163 F.2d 590 (D.C. Cir. 1947), a corporation was compelled by state law to collect certain payments, but disclaimed the right to the payments on the grounds the law violated the state constitution and then mounted a legal challenge to force their return. The court of appeal opined that "The statement of the Supreme Court in the *North American Oil* case, *supra*, that if a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income, clearly implies that if a taxpayer receives amounts without any claim of right and under compulsion of law to receive them, although over his objection, he has not received income; at least not unless his denials and protests are eventually overruled. If the Supreme Court had meant that the receipt of sums was income, whether

or not under claim of right, the recitation of the qualifying phrase in the opinion was meaningless." *Id., 592-593.*

In *United States v. Merrill*, 211 F.2d 297 (9th Cir. 1954), the taxpayer received a payment pursuant to a claim of right, but then before the end of the tax year decided his claim was invalid and made bookkeeping entries to reflect his changed position. The Court of Appeal wrote, "The usual case for application of the rule involves a taxpayer who has received funds during a taxable year, who maintains his claim of right thereto during that year, and who subsequently, in a later year, is compelled to restore the sum when his claim proves invalid. We are not aware that the rule has ever been applied where, as here, in the same year that the funds are mistakenly received, the taxpayer discovers and admits the mistake, renounces his claim to the funds, and recognizes his obligation to repay them. We think there is no warrant for extending the harsh claim of right doctrine to such a situation." *Id., 304.*

In *James v. United States*, 366 U.S. 213 (1961) this Court reconsidered the taxability of embezzled funds. The Court determined that *Commissioner v. Wilcox* was wrongly decided, and that embezzled funds did constitute taxable income. In connection with that conclusion, it wrote the following:

> When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as

> to their disposition, "he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." *North American Oil Consolidated v. Burnet, supra,* at 286 U. S. 424.

Id., 219. This new sentence is inconsistent with the original statement in *North American Oil.* Specifically, the first part of the sentence has been rewritten, dropping the phrase "claim of right" and replacing it with a test of whether there is a "consensual recognition ... of an obligation to repay."

It seems unlikely that Court in *James* really intended to change established doctrine as it applied to honest taxpayers. The *James* opinion is a short one, entirely focused on whether or not to overturn *Wilcox.* In that context, *James'* consensual recognition test makes sense, for clearly an embezzler's obligation to return his booty is meaningful only if made known to the victim. Since *James* didn't consider the case of a man who honestly comes into possession of money that does not belong to him, any pronouncements relating to such circumstance must be considered dicta. Nevertheless, emanating as it does from powerful authority, the resulting dicta is exceedingly problematic for taxpayers whose honesty is not in question.

Take for example the case of *Smarthealth, Inc. v. Commissioner, T.C. Memo* 2001-145 (2001). The taxpayer there sent customers both invoices and

statements, and customers sometimes paid against both. The taxpayer claimed a right to only one payment, crediting overpayments to the customers' accounts. It seems obvious that the duplicate payments would not be taxable under *North American Oil*, *Sohio* and *Merrill* because the taxpayer never claimed a right to them, and the Tax Court should have been able to write a very short opinion disposing of the case on this ground. However, the commissioner argued that simply crediting the customer's accounts didn't constitute the consensual recognition of the obligation by the customer required by *James*. The commissioner didn't question the taxpayer's honesty, or dispute that the customers would eventually receive their credit. The Tax Court's analysis began with the ritual citation that "The claim of right doctrine was established by the Supreme Court in *North Am. Oil* ..." but then immediately switched to confronting the test set forth in *James*. *Id. 9.* The court struggled to reconcile the *James* test with its visceral sense that *North American Oil* had not been overruled and still required there be a claim of right for receipts to be taxable. It eventually decided that the overpayments weren't taxable because "[taxpayer] did not acquire the customer overpayments through any form of deceit," and stated that although "[taxpayer] did not routinely inform its customers of the existence of the customer credit balances, we do not view this factor as decisive." *Id. 12.* In essence, the court admitted disregarding the *James* test. Although the outcome

was just, the analysis was not exactly a *tour de force* of intellectual honesty.

In the case at issue here, it is undisputed that Petitioner explicitly disclaimed the right to the tendered payment at all times during the tax years under review. Among other things, the payment was prohibited by state corporation law, Petitioner's participation in the transaction would constitute a misdemeanor, Petitioner knew this, and Petitioner acknowledged this in state court. Petitioner's actions were the antithesis of the embezzler's actions in *James*. It was O'Dowd who was being dishonest here, forcing a transaction which violated corporation law. Petitioner clearly did not claim a right to the tendered payment, and the Tax Court should have followed *North American Oil*, *Sohio*, and *Merrill*. Indeed, the facts of this case are almost identical to those of *Sohio*, the only difference being that in *Sohio* the taxpayer acted under duress because of penalties threatened by state law and here Petitioner acted under duress because of penalties threatened by an arbitrator.

Instead, although the Tax Court began its analysis with the ritual citation of *North American Oil*, it ignored the question of whether the tendered payment was received under a claim of right and decided the case based on the alternate standard first elucidated in *James*:

> What we believe is controlling is that, like the taxpayers in *Hope v. Commissioner*, *supra*, and *Miller v. Commissioner*, *supra*,

> Petitioner's renunciation of the right to the amount received was not coupled with an unconditional agreement or understanding with another party to return the amount received.

Hightower, 16. The Court of Appeal affirmed on the same reasoning: "[Petitioner] had no fixed legal obligation to restore the funds to any other party." *Hightower v. Commissioner*, 266 Fed. Appx. 646, 647.[7]

If the *James* test has indeed replaced the *North American Oil* test, the claim of right doctrine is misnamed and tax practitioners are generally unaware of this fact. Tax references invariably begin their discussions of the claim of right doctrine by citing *North American Oil* as the definitive statement of the doctrine and state that the existence of a claim of right to received funds is a necessary precondition for received funds to be taxable. See for example Stephen F. Gertzman, *Federal Tax Accounting* (2d. ed. 1993, Warren Gorham Lamont), ¶12.03. Accountants all over the

[7] Actually, Petitioner did have a legal obligation to restore the tendered payment, since accepting it would violate state corporation laws and constitute a misdemeanor. Neither the arbitrator or the state courts ever held otherwise, as the arbitrator ruled that Petitioner didn't have standing to raise that objection and the state courts dismissed Petitioner's challenge based on arbitral finality. O'Dowd even acknowledged in court filings that Petitioner was obligated to return the funds if his view of the law was correct. Petitioner thus presented credible evidence that he had such a legal obligation, and it was incumbent on the Commissioner to show otherwise. Section 7491(a). This is an exceedingly high bar, as it is beyond the competence of the Commissioner, and even of the Tax Court, to declare the Petitioner's position invalid.

United States are thus advising their clients based on the test, "Did you claim a right to the money?" However, under *James,* and now under *Hightower*, we find the test is really, "Did you have an unconditional agreement to return the amount received?" Because *James* itself dealt with the special case of embezzled money, commentators have not yet appreciated its collateral effect on the affairs of honest taxpayers; hence cases like *Smarthealth* and this one.

Which standard applies to honest taxpayers: that set forth in *North American Oil*, *Sohio* and *Merrill*, all of which concerned honest taxpayers, or that set forth in *James*, which concerned an embezzler? This is an exceedingly important question, for as this Court noted, "The 'claim of right' interpretation of the tax laws ... is now deeply rooted in the federal tax system." *United States v. Lewis*, 340 U.S. 590, 592 (1952). This Court created the dichotomy, and only this Court can resolve it. This case provides a clear and simple fact pattern on which to base an opinion.

Even if the *James* Test Was the Correct Standard, It Must Be Reconsidered in Light of New Section 7491(a).

The *James* test is one of credibility, premised on the presumption that a taxpayer will not return money absent an express agreement with its true owner. As discussed previously, Congress has since enacted Section 7491(a) and declared its intention that taxpayers who introduced credible evidence

were generally to be believed. Under this new paradigm, the credibility test set forth in *James* is too strict when applied to taxpayers whose honesty is not at issue. Since Petitioner provided credible evidence that he did not claim a right to the funds, the burden must shift to the Commissioner to prove otherwise.

III. By Using Reasoning other than Tracing to Whom Benefits and Liabilities of Ownership Actually Flow to Determine Who Should Bear the Tax Consequences, the Tax Court (affirmed by the Court of Appeals) Created Precedent that Conflicts with a Large Body of Tax Law.

A. O'Dowd, Not Petitioner, Received All of the Benefits Attributable to Petitioner's Shares after December, 1999.

Beneficial ownership of stock, not mere record ownership or other formal indicia, determines who bears the tax consequences. (See *Beirne v. Commissioner*, 52 T.C. 210 (1969); *Duarte v. Commissioner*, 44 T.C. 193 (1965).) With respect to an S corporation, "Beneficial, not mere record, ownership of a share is a prerequisite to 'shareholder' status." (*Wilson v. Commissioner*, 560 F.2d 687, 687 (5th Cir. 1977).) When there are two possibilities for beneficial owner, the Tax Court must trace the flow of benefits and liabilities to see where the bulk of them flow. *Pacific Coast Music Jobbers, Inc. v. Commissioner*, 457 F.2d 1165 (5th Cir. 1972), *Yelencsics v. Commissioner*, 74 T.C. 1513 (1980)

Rights of stock ownership include the right to vote the shares, to receive a proportional share of dividends and to enjoy any appreciation in the stock's value. For close corporations there can also be rights to participate in affairs of the company. In the tax

year in question, Petitioner was denied all of these rights and O'Dowd exercised them.

In the process of forming Green Hills and buying out a previous shareholder, Petitioner had ensured himself a say in the management of the company by arranging (a) to own 50% of the stock, thereby guaranteeing the ability elect one of the two directors (ER-22 3, ER-13 26.), (b) to have himself elected Chairman and Secretary (ER-22 3, ER-13 26.), (c) for the bylaws to guarantee him access to the properties and books of the company (ER-9.7 6), and (d) for a guarantee that the company would make quarterly distributions of 75% of the net income from the previous quarter (ER-9.4 2.)

In March of 1998, O'Dowd locked Petitioner out of the company, thereby denying him his rights of access and inspection, and rejected his request for monthly directors meetings, thereby denying him his role in managing the company. (ER-22 4.) In October 1998, Petitioner again requested there be monthly directors meetings, O'Dowd again refused. (ER-9.12.) The director elected by Petitioner's shares was thus blocked from serving. Petitioner did, however, continue to receive distributions.

In December of 1999 the arbitrator issued the December 1999 award finding for O'Dowd in the arbitration. (ER-22 5) The practical effect of this award was to render Petitioner's continued record ownership a mere formality pending a finalization of the details of transfer of ownership. Freed of any concern for the consequences, O'Dowd immediately

stopped the payment of further quarterly distributions. (ER-22 4, ER-13 46.) From this point on, O'Dowd treated the company as if he already owned it.

The specific arrangements for the formal transfer of ownership were set forth in the Partial Final Award issued a few months later. The Tax Court found as fact that "The award permitted O'Dowd to treat the purchase of Petitioner's stock as having occurred on September 24, 1998." *Hightower*, 5. Among other things, the award provided that:

> Because [O'Dowd] was entitled to complete the purchase of [Petitioner]'s shares on September 24, 1998, a remedy must be fashioned that gives [O'Dowd] the benefit of his bargain under the Shareholders Agreement. ... The intent of this award is to provide [O'Dowd] with the benefit of the prior deal as closely as that may now be approximated.

(ER-9.21 16-17.) It then proceeded to strip Petitioner of all the financial benefits of stock ownership he might have received since 1998 and transfer them to O'Dowd:

> The purchase price shall be offset and reduced by all dividends and salary (net after payment of income taxes) paid to [Petitioner] for the period after September 24, 1998, which means specifically dividends and salary for the fourth quarter of 1998 and later.

(ER-9.21 18.) The arbitrator's effecting of a September 24, 1998 purchase date meant that it was O'Dowd, not Petitioner, who received the benefits associated with Petitioner's shares in 2000, the tax year at issue here. Most significantly, it was O'Dowd, not Petitioner, who benefited from the use of the over $47 million in capital represented by those shares. This made O'Dowd the clear beneficial owner. Since Petitioner was not the beneficial owner of the stock, he is not chargeable with the tax consequences of ownership.

B. The Tax Court Did Not Evaluate the Facts to Determine Who Controlled or Had the Economic Benefit of Ownership.

There are only two candidates for beneficial owner here: Petitioner and O'Dowd. To determine which it was, the Tax Court had to trace the control and economic benefits associated with Petitioner's shares and determine whether they flowed more to Petitioner or more to O'Dowd. It didn't do this. Instead, it gave two reasons for holding Petitioner liable. The first reason was a general statement that a diminished role in the corporation as a result of having a poor relationship with the other shareholder was insufficient grounds for relieving a shareholder from pass-through of profits. (ER-22 20-21.) This reason at best understated the true situation, and it completely ignored the fact that all of the financial benefits of stock ownership flowed to O'Dowd as well. The Tax Court's second reason was that the arbitrator had increased the amount paid

Petitioner by an amount necessary to cover the taxes associated with his shares, and that Petitioner would receive a windfall if he were not required to use that amount to pay those taxes. *Hightower*, 21-22. The Tax Court thus used criteria other than beneficial ownership to conclude that Petitioner was liable for the taxes. The Tax Court's opinion has already been cited as precedent. *Dunne v. Commissioner*, T.C. Memo 2008-63, 24.

C. The Tax Court's Second Reason Actually Supports the Argument That O'Dowd Was the Beneficial Owner of Petitioner's Shares.

The Tax Court's second reason for attributing the income to Petitioner was that the arbitrator provided Petitioner with a credit in the amount of the income tax that would be due:

> [T]he payment to [Petitioner] for his Green Hills stock was increased by approximately the amount of [Petitioner]'s Federal income tax on a 50-percent distributive share of income from Green Hills. [Petitioner] received through the arbitrator's award a payment compensating him for his increased Federal income tax liability. [Petitioner] would receive a windfall if he were not required to pay the tax which was already paid to him as part of the sale of his Green Hills stock.

Hightower, 21-22. The Tax Court's logic was faulty. The arbitrator's stated objective was to arrange

affairs to be as they would be if the sale was effective September 24, 1998. (ER-9.21 16-17.) He was obviously concerned that, as owner of record, Petitioner would be liable for the tax on the income attributable to his shares; such liability would be inconsistent with his objective of transferring *all* consequences of ownership after that date, negative as well as positive, to O'Dowd. Because the purpose of the arbitrator's allowance was to ensure that the tax consequences of share ownership were borne by O'Dowd, the existence of that allowance actually supports Petitioner's contention that the award made O'Dowd the beneficial owner of the shares.

Judging Petitioner to be the beneficial owner here leads to a contradiction: If Petitioner is the beneficial owner, his benefit will be zero and all benefits and costs of stock ownership will flow to O'Dowd, making O'Dowd the clear beneficial owner. But if O'Dowd is the beneficial owner, Petitioner cannot be.

If Petitioner is judged *not* to be the beneficial owner, then the arbitrator's misunderstanding of tax law would indeed result in a small "windfall" to Petitioner. That "windfall" would be attributable to arbitrator error (due to his misunderstanding of tax law), not to beneficial ownership, and so should have been of no concern to the Tax Court. The vast bulk of the benefits and risks of stock ownership would still flow to O'Dowd.

D. The Question of Beneficial Ownership Was Decided Under the Wrong Standard of Proof.

Petitioner introduced credible evidence that O'Dowd, not Petitioner was the beneficial owner of the shares. Accordingly, the Tax Court was required to shift the burden of proof on that question to the Commissioner. Section 7491(a). Instead, it began with the presumption that Commissioner's determination was correct, *Hightower*, 12, and marshaled its arguments to support that presumption.

CONCLUSION

Hightower v. Commissioner, affirmed by the 9th Circuit Court of Appeals, is citable precedent standing for the propositions that (1) a rule of evidence enacted by Congress because it would create a better balance between the IRS and taxpayers and expressly labeled "General rule" only applies if explicitly invoked by a taxpayer, (2) a person who through no fault of his own comes to hold funds illegally thrust upon him and immediately initiates action to return those funds is nevertheless taxed on those funds, and (3) there are occasions where income from an asset can be taxed to someone other than the beneficial owner. None of these propositions should be allowed to become the public policy of the United States.

This Petition for Writ of Certiorari should be granted. In such event, Petitioner requests leave to be represented by appropriate counsel. In the alternative, the Court of Appeals should be directed to issue a published opinion with respect to all matters presented.

Respectfully submitted,

GLENN HIGHTOWER
Pro se

July, 2008

APPENDIX A: *Hightower v. Commissioner*, TC Memo 2005-274

T.C. Memo. 2005-274

UNITED STATES TAX COURT

GLENN HIGHTOWER, Petitioner v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 8679-04. Filed November 28, 2005.

Petitioner (P) and Daniel O'Dowd each owned 50 percent of the stock of an S corporation (GH). O'Dowd exercised his rights under the shareholders' agreement to buy P's shares. P opposed the buyout in arbitration proceedings to which P and O'Dowd had agreed to be bound. In 2000, the arbitrator ruled against P, and P received $41,585,388 in exchange for his GH stock. P deposited the payment in an interest-bearing account. From 2000 to 2003, P unsuccessfully opposed the buyout in California State courts.

P received no dividends from GH in 2000, but he retained the right to receive dividends and vote his shares of GH stock.

Held: P is taxable on the payment he received for his GH stock and related interest in the years paid.

Held, further, P is taxable on a distributive share of GH's income in 2000.

Glenn Hightower, pro se.

Catherine Campbell, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

COLVIN, Judge: Respondent determined deficiencies in petitioner's Federal individual income tax of $7,535,620 for 2000 and $389,455 for 2001. After respondent's concession,[1] the issues for decision are:

1. Whether $41,585,388 petitioner received in 2000 in a corporate stock buyout of his shares in an S corporation and interest credited in 2000 and 2001 to the account in which he deposited the payment is included in petitioner's income for those years. We hold that it is.

2. Whether petitioner is required to include in income for taxable year 2000 a distributive share of the S corporation's 2000 income. We hold that he is.

Unless otherwise indicated, section references are to the Internal Revenue Code as amended in effect for the years in issue, and Rule references are to the Tax Court Rules of Practice and Procedure.

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[1] Respondent concedes that the amount of petitioner's unreported interest income for 2001 is $44,021 less than respondent determined in the notice of deficiency.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. Petitioner resided in Issaquah, Washington, when the petition in this case was filed.

A. Green Hills Software, Inc.

1. Formation

Daniel O'Dowd (O'Dowd), petitioner, and a third individual organized Green Hills Software, Inc. (Green Hills), as a California corporation in 1986. Green Hills became a Delaware corporation in 1986. Green Hills was an S corporation for Federal income tax purposes at all relevant times.

Petitioner and O'Dowd bought the stock of the third individual in 1992. They each owned 30,000,300 shares thereafter. Petitioner was chairman of the board and secretary, and O'Dowd was president and treasurer. Petitioner and O'Dowd were Green Hills' only directors.

2. Buyout Provisions in the Shareholders' Agreement

Petitioner and O'Dowd entered into a shareholders' agreement in 1992 which provided that any dispute between them would be resolved through binding arbitration. It also provided that either of them could compel a buyout of the stock held by the other at a price determined by a formula.

3. Events Leading to O'Dowd's Buyout of Petitioner's Stock

Relations between O'Dowd and petitioner deteriorated in 1997 and 1998. Petitioner went to Green Hills' headquarters on March 15, 1998. O'Dowd demanded that petitioner leave and threatened to call the police if petitioner refused. On March 25, 1998, O'Dowd notified petitioner that his access to the company was denied, that the locks had been changed, and that his employment and access to the computer system had been terminated.

Petitioner was the record owner of his shares until October 13, 2000. He retained the right to vote his stock and to receive dividends until that date. He received dividends in 1998 and 1999, no dividends in 2000, and a salary of $13,822 in 1998, $51,381 in 1999, and $16,666 in 2000.

4. O'Dowd's Buyout of Petitioner

In a letter dated June 26, 1998, O'Dowd properly triggered the buy/sell provision of the shareholders' agreement by offering either to sell his shares to petitioner for $47 million or to buy petitioner's shares for $47 million. The letter also stated that O'Dowd had deposited with Green Hills a certified check for $47 million payable to petitioner in conformity with the shareholders' agreement. Petitioner did not want to sell his stock. Instead, he wanted to exercise his right under the shareholder's agreement to buy O'Dowd's stock for the amount O'Dowd had offered for petitioner's stock ($47 million).

However, petitioner could not obtain financing. Thus, O'Dowd compelled a buyout of petitioner's stock.

B. Arbitration

1. Proposed Interim Award

On August 24, 1998, pursuant to the arbitration clause of the shareholders' agreement, petitioner demanded arbitration regarding O'Dowd's buyout. On December 1, 1999, the arbitrator issued a proposed interim award (the December 1999 award) finding that O'Dowd had not acted improperly in his attempt to buy petitioner's shares. The December 1999 award stated that the arbitrator would reassess the award after considering motions for reconsideration and entry of partial final award.

2. Partial Final Award

The arbitrator issued a partial final award on March 8, 2000. The arbitrator found that O'Dowd's actions were consistent with the buyout provision of the shareholders' agreement. The award permitted O'Dowd to treat the purchase of petitioner's stock as having occurred on September 24, 1998, 90 days after O'Dowd invoked the buyout provision of the shareholders' agreement. The arbitrator made the following findings: (a) But for petitioner's failure to tender his shares to O'Dowd within 90 days of O'Dowd's deposit of $47 million with Green Hills, his legal or beneficial interest in Green Hills would have terminated on September 24, 1998; (b) O'Dowd has the right but not the

obligation to pay or cause Green Hills to pay petitioner for the shares ($47 million) by September 24, 1998; (c) the purchase price shall be reduced by dividends and salary (net after payment of taxes) paid to petitioner for the period after September 24, 1998; and (d) until O'Dowd completes the purchase of petitioner's stock, petitioner shall be paid all dividends in accordance with the shareholders' agreement, which payments shall offset the purchase price for the shares.

3. Corrected Partial Final Award

The arbitrator issued a corrected partial final award on April 25, 2000, which provides in pertinent part:

> The purchase price shall be offset and reduced by all dividends paid to * * * [petitioner] based on Green Hills' earnings for the Third Quarter of 1998 and thereafter until the date of purchase of * * * [petitioner's] share; said offset shall be reduced by the amount of ordinary taxable income of Green Hills (excluding long term capital gains) attributable to * * * [petitioner] for the period September 24, 1998 until the purchase date multiplied by a fraction the numerator of which is .1367 and the denominator of which is .7070.

Petitioner filed a petition in the California Superior Court for the County of Los Angeles (the Superior Court) and a petition for writ of mandate in the Court of Appeal of the State of California for the Second District (the Court of Appeal) in an effort to have the partial final award vacated. Both petitions were denied.

C. Payment to Petitioner for His Green Hills Stock

1. Adjusted Purchase Price

Green Hills hired an accountant to compute the adjusted purchase price pursuant to the corrected partial final award.[2] The accountant estimated the adjusted total purchase price for petitioner's shares to be $42,862,230.95 as of October 15, 2000.

2. Delivery and Deposit of Payment

On October 13, 2000, O'Dowd delivered checks to petitioner in the amounts of $32,585,388 and $9 million as payment for petitioner's shares in Green Hills. Both checks were dated October 13, 2000. The face and endorsement areas of each check indicated that the check was not valid if presented for payment after October 23, 2000. O'Dowd drafted a receipt for the checks that read in pertinent part: "Receipt of * * * [checks] aggregating $41,585,388 as payment for all of the shares of Glenn Hightower in Green Hills Software, Inc. is hereby acknowledged." Petitioner crossed out the phrase "as payment for all of the shares of Glenn Hightower in Green Hills Software, Inc.", signed the receipt, and deposited the checks in an interest-bearing bank

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[2] The accountant computed the adjustment by, among other things, subtracting $3,163,484 of dividends paid in 1998 and 1999 and adding .1367/.7070 of $6,251,054 total ordinary taxable income for 1998 and 1999, and .1367/.7070 of $3,494,666 estimated ordinary taxable income for 2000 through Oct. 15, 2000. The payment to petitioner was increased by approximately the amount of petitioner's Federal income tax on a distributive share of income from Green Hills. See par. B. in Opinion, below.

account that petitioner had opened in his own name solely to hold the funds.

In a letter to O'Dowd dated October 13, 2000, petitioner's attorney stated: (a) Petitioner would tender his shares of Green Hills to O'Dowd, as required by the arbitrator's award under protest, and without waiver of any rights or remedies; (b) the shares were to be held in trust; and (c) petitioner was not entitled to the checks. Petitioner delivered his stock to O'Dowd on October 13, 2000. Petitioner did not endorse the shares.

Interest was credited to petitioner's account in the amounts of $469,593.63 in 2000 and $1,513,788.28 in 2001. There were no transactions on the account in 2000 or 2001 other than the crediting of interest and withholding of Federal income tax.

In a letter to petitioner's attorney dated November 21, 2000, O'Dowd's attorney stated that the account into which petitioner had deposited the $41,585,388 was not a trust account. O'Dowd's attorney offered to hold the funds for petitioner in the attorney's trust account. Petitioner did not respond to the offer.

D. Later Events Relating to the Arbitration

In February 2001, the Court of Appeal denied petitioner's request to stay the arbitration proceedings. Petitioner filed a motion for rehearing with the Court of Appeal, and the motion was denied. Petitioner filed a petition for review in the Supreme

Court of California on March 28, 2001. The petition was denied on May 16, 2001.

The arbitrator issued a final award in the arbitration proceedings on August 29, 2001. He found that: (1) O'Dowd's purchase of petitioner's Green Hills stock for $41,585,388 complied with the partial final award and was effective on October 13, 2000; (2) the payment belongs to petitioner without restriction; (3) petitioner's acceptance of the payment on October 13, 2000, terminated his interest in Green Hills; (4) petitioner is entitled to an additional $52,783;[3] (5) O'Dowd is entitled to $604,105.30 for attorney's fees, costs, and expenses; and (6) the net amount petitioner owes O'Dowd is $551,322.30.

On December 11, 2001, petitioner petitioned the Superior Court to vacate the arbitration award. On December 21, 2001, the Superior Court entered a judgment confirming and substantially repeating the findings in the arbitrator's final award.

Petitioner appealed the Superior Court's decision. On July 31, 2003, the Court of Appeal filed its opinion rejecting petitioner's appeal and affirming the decision of the Superior Court. Petitioner filed a motion for rehearing on August 15, 2003. Petitioner's motion was denied on August 20, 2003. Petitioner filed a petition for review in the Supreme Court of

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[3] This adjustment was made to correct an error in the calculation of the offsets to the purchase price.

California on September 9, 2003. That petition was denied on October 22, 2003. No other actions concerning the validity of the buyout were pending on the date of trial.

E. Petitioner's Basis in Green Hills Stock, Distributive Share of Income From Green Hills, and Income Tax Returns for 2000 and 2001

Petitioner's basis in Green Hills stock was $8,315,584 on December 31, 1999. Green Hills reported $4,275,909 as petitioner's distributive share of income through October 13, 2000.[4]

Petitioner filed Federal income tax returns for 2000 and 2001 on the cash receipts and disbursements method of accounting. On his 2000 return, petitioner did not include a distributive share of income from Green Hills. Petitioner did not include in income on his 2000 and 2001 returns the $41,585,388 payment or any of the interest credited to the account in which he had deposited that payment.

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[4] In the notice of deficiency, respondent determined that petitioner's basis in Green Hills was $12,523,085 for purposes of determining petitioner's gain on the sale of Green Hills stock on Oct. 13, 2000. Adding a $4,275,909 distributive share of income to petitioner's basis in Green Hills of $8,315,584 on Dec. 31, 1999, does not produce the basis determined by respondent. The record does not show whether respondent determined petitioner's basis correctly. Thus, if we decide that the $41,585,388 is includable in petitioner's income in the year received, the parties shall compute the amount of gain under Rule 155.

OPINION

A. Whether the Payments at Issue Are Taxable to Petitioner in the Years Received

1. Contentions of the Parties

The parties dispute whether the payment to petitioner for the stock buyout and related interest are taxable to petitioner in 2000 and 2001. Petitioner contends that those amounts are not taxable in those years because of the claim of right doctrine. Respondent disagrees.[5] We agree with respondent.

Income includes all economic gains not specifically exempted from taxation. See sec. 61; Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955). Income is generally taxable in the year in which the taxpayer receives it unless, under the method of accounting used by the taxpayer, the amount is properly taxable in another year. Sec. 451(a). For taxpayers using the cash method of accounting, income is taxable in the year actually or constructively received. Sec. 1.451-1(a), Income Tax Regs.

Under the claim of right doctrine, a payment is includable in income in the year in which a taxpayer receives it under a claim of right (even if that claim is disputed by another party)

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[5] Income generally includes proceeds of a stock sale (less a taxpayer's basis) and interest on money received. Secs. 61(a)(3), (4), 1001. Respondent contends that petitioner received income in the amount of the gross proceeds less his basis in the stock, plus all of the interest credited to the account in which he had deposited that payment.

and without restriction as to its disposition.[6] Healy v. Commissioner, 345 U.S. 278, 281-282 (1953); United States v. Lewis, 340 U.S. 590, 591 (1951); N. Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932).[7] The claim of right doctrine results in part from the requirement to account for income annually. Healy v. Commissioner, supra at 281; United States v. Lewis, supra at 592; Burnet v. Sanford & Brooks Co., 282 U.S. 359, 363 (1931).

The burden of proving a factual issue relating to liability for tax shifts to the Commissioner under certain circumstances. Sec. 7491(a). Petitioner does not contend that section 7491 applies. Thus, petitioner bears the burden of proof. See Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933).

2. Whether the Payments at Issue Are Taxable in the Years Received

We next consider petitioner's argument that, under the claim of right doctrine, petitioner is excused from the general rule that income is taxable in the year in which the taxpayer receives

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[6] See generally Lister, "The Use and Abuse of Pragmatism: The Judicial Doctrine of Claim of Right", 21 Tax L. Rev. 263 (1966).

[7] In N. Am. Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932), the Supreme Court articulated the claim of right doctrine as follows:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

it. Petitioner contends that the general rule does not apply because the conditions for application of the claim of right doctrine (i.e., receipt of income under a claim of right and without restriction as to its disposition) have not been met.

a. Whether Petitioner Received Income in 2000 and 2001

Petitioner argues that he did not receive a payment from O'Dowd in 2000 because he held O'Dowd's payment in trust in a segregated account. We disagree. Petitioner received the funds and deposited them in an account he had opened in his name. There is no evidence that petitioner held the funds in trust.

Petitioner argues that the funds were not income until the litigation was final and that the sale was incomplete because he tendered his shares without endorsing the certificates. We disagree. The arbitrator found in the partial final award in 2000, which the California courts later affirmed, that petitioner's stock was purchased in 2000. We conclude that petitioner received payment for his stock in 2000 when he received the checks and that he received interest thereon in 2000 and 2001 when it was credited to the bank account into which he had deposited the payment. This result is not changed by the fact that petitioner did not endorse the stock certificates.

b. Whether Petitioner's Disposition of the Funds Was Restricted

Petitioner deposited the stock payment in an interest-bearing account which he established solely to hold those funds. He did not withdraw or otherwise use the payment or interest credited to that account during the years at issue. However, absence of use of funds by a taxpayer does not prevent inclusion of the funds in income under the claim of right doctrine. See Commissioner v. Alamitos Land Co., 112 F.2d 648, 650-651 (9th Cir. 1940), revg. 40 B.T.A. 353 (1939) (funds received in litigation were income in year paid even though the funds were shown on the taxpayer's books as a reserve to be repaid to an adverse litigant if successful on appeal).

Petitioner argues that his use of the funds was restricted by State law in that if he accepted the funds, Green Hills would have negative retained earnings which is prohibited by California and Delaware law.[8] Even if payment of the funds to petitioner violated State law, a subsequent determination to that effect would not absolve petitioner from his tax liability in the year of the receipt. See Healy v. Commissioner, supra; Wentworth v. Commissioner, 510 F.2d 883, 886 (6th Cir. 1975), affg. T.C. Memo. 1973-199; Hamlett v. Commissioner, T.C. Memo. 2004-78.

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[8] The parties do not contend that the result on this issue differs depending whether California or Delaware law applies.

c. Whether Petitioner's Opposition to the Buyout Precludes Taxation of the Payments in the Years the Payments Were Received

Petitioner contends that under the claim of right doctrine the payments are not taxable to him in the years he received them because he opposed the stock buyout, he established a separate, interest-bearing account to hold the payments, and he did not use the funds during the years in issue.

Contrary to petitioner's contention, a payment properly made to a taxpayer is includable in income in the year paid if, as here, the taxpayer (a) receives and deposits the payment in an unrestricted account, (b) seeks to invalidate the transaction or circumstance which caused the payment to be made, and (c) has no fixed obligation to pay the amount to another party. Hope v. Commissioner, 471 F.2d 738, 741-742 (3d Cir. 1973) (sale of stock taxable in year of sale despite taxpayers' efforts to rescind stock sale in that year), affg. 55 T.C. 1020 (1971). In addition, a taxpayer is taxable in the year the taxpayer receives wages where the taxpayer tried to return the wages to her employer and the employer refused to accept repayment. Miller v. Commissioner, T.C. Memo. 1963-341, affd. without published opinion 15 AFTR 2d 321, 65 USTC par. 9,288 (9th Cir. 1965). In both of these cases, like the instant case, the taxpayer's renunciation was not accepted by the other party.

A payment may not be taxable in the year it is received if, in that year, the recipient-taxpayer recognizes an unconditional obligation to pay it to another party. See Bates Motor Transp. Lines, Inc. v. Commissioner, 200 F.2d 20, 24 (7th Cir. 1952), affg. 17 T.C. 151 (1951). As another example, amounts paid by a customer to a taxpayer were not income in the year received to the extent that the taxpayer acknowledged an obligation to pay the amounts to the taxpayer's supplier, even though the agreement was unenforceable. Lashells' Estate v. Commissioner, 208 F.2d 430, 435 (6th Cir. 1953), affg. in part, revg. in part and remanding a Memorandum Opinion of this Court; Shaara v. Commissioner, T.C. Memo. 1980-247.

Petitioner asserts that Hope v. Commissioner, supra, is distinguishable because in Hope the taxpayers instituted the stock sale and then tried to rescind it, while petitioner opposed the transaction from the beginning. We disagree that this factual distinction is significant. What we believe is controlling is that, like the taxpayers in Hope v. Commissioner, supra, and Miller v. Commissioner, supra, petitioner's renunciation of the right to the amount received was not coupled with an unconditional agreement or understanding with another party to return the amount received.

Petitioner relies on United States v. Merrill, 211 F.2d 297, 302-303 (9th Cir. 1954).[9] In that case, the Court of Appeals for the Ninth Circuit held that a payment mistakenly made to a taxpayer who had no right to receive it is not taxable in the year of receipt if, in that year, the taxpayer renounces any claim to the funds, recognizes an obligation to repay, and makes provision for repayment in the form of a journal entry on the taxpayer's books. Id. at 303-304. Petitioner's situation differs from that of the taxpayer in Merrill because the payment of funds to petitioner was not a mistake, petitioner had the right to receive the funds, and there was no existing agreement with O'Dowd to return the payment. In Bates Motor Transp. Lines, Lashells' Estate, and Merrill, each recipient of funds had an agreement with another party during the year of receipt to return the funds.

Petitioner contends that he involuntarily received the funds, that he unconditionally renounced his right to them, and that he thought that not cashing the checks may have caused him to lose the $41,585,388 or be subject to the cost of financing an additional purchase. We disagree. He voluntarily cashed the checks he received. Creating a separate account to hold the

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[9] We relied on the holding in United States v. Merrill, 211 F.2d 297, 302-303 (9th Cir. 1954), in Bishop v. Commissioner, 25 T.C. 969, 974 (1956). See also Gaddy v. Commissioner, 38 T.C. 943, 947-948 (1962), affd. in part and remanded in part on another issue 344 F.2d 460 (5th Cir. 1965).

funds does not show that petitioner unconditionally renounced his right to the funds. Petitioner's renunciation was not pursuant to an "existing" or "fixed" agreement to return the funds. On the contrary, petitioner intended to return the funds only if he succeeded in rescinding O'Dowd's buyout.[10]

d. Conclusion

As stated above, income is generally taxable in the year in which the taxpayer receives it unless, under the method of accounting used by the taxpayer, the amount is properly taxable in another year. Sec. 451(a). Under the claim of right doctrine, this principle applies to income received by a taxpayer and over which the taxpayer has unrestricted use, even if the taxpayer's claim to the income is disputed by another party. Petitioner accepted and kept the payment and related interest

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[10] Neither party cited Sohio Corp. v. Commissioner, 163 F.2d 590 (D.C. Cir. 1947), revg. 7 T.C. 435 (1946). In that case, the Court of Appeals for the District of Columbia held that a taxpayer which (1) was required by Illinois law to receive income, (2) would have been subject to monetary penalties if it had not received the income, (3) protested the payment, and (4) immediately commenced and later prevailed in a court challenge to the constitutionality of the statute under which the payment was received did not have income in the year of receipt. Id. at 593.

Petitioner's situation is distinguishable from that of the taxpayer in Sohio Corp. v. Commissioner, supra. The taxpayer in Sohio Corp. did not receive and retain the payment voluntarily, but rather did so under the compulsion of State law and the threat of heavy penalties. Id. at 593. In contrast, petitioner agreed to be bound by the shareholders' agreement that contained the buyout provision and arbitration procedures. The receipt, retention, and deposit of funds in petitioner's bank account were voluntary.

until he learned if his appeal would be successful. Under these circumstances, we hold that the payment and related interest are taxable in the years petitioner received them.

B. Whether Petitioner Must Include in His Income a Distributive Share of Green Hills' Income

The next issue for decision is whether petitioner must include in his income for 2000 a distributive share of Green Hills' income from January 1 to October 13, 2000.

1. Taxation of S Corporation Income

Generally, income, losses, deductions, and credits of an S corporation are passed through pro rata to shareholders on their individual income tax returns based on days of ownership whether or not the income is distributed. Secs. 1363(a), 1366(a), 1366(c), 1377(a)(1). Ordinarily, the person who would be taxable on a dividend if the corporation were a C corporation is considered to be the shareholder of an S corporation. Sec. 1.1361-1, Income Tax Regs.11

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11 Sec. 1.1361-1, Income Tax Regs., provides in part:

(e) Number of Shareholders. (1) * * * Ordinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation. * * * The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation for purposes of this paragraph (e) and paragraphs (f) and (g) of this section. * * *

2. Petitioner's Contentions

When the record owner of S corporation stock holds that stock for the benefit of another, such as a nominee, agent, or passthrough entity, income, losses, deductions, and credits of the corporation are passed through not to the record owner but to the beneficial owner of the stock. Sec. 1.1361-1(e), Income Tax Regs. A taxpayer is the beneficial owner of property if the taxpayer controls the property or has the economic benefit of ownership of the property. Anderson v. Commissioner, 164 F.2d 870 (7th Cir. 1947), affg. 5 T.C. 443 (1945).

Petitioner contends, in effect, that he was not the beneficial owner of his Green Hills stock in 2000, and no Green Hills income passes through to him, because beginning before 2000 O'Dowd improperly excluded him from the benefits of ownership of that stock. We disagree.

First, petitioner has cited no authority for the proposition that a record owner of S corporation stock is not subject to pass through of S corporation income because the record owner has a diminished role in the corporation as a result of having a poor relationship with another shareholder. Courts have frequently considered whether an individual is a beneficial owner of the stock of an S corporation in deciding whether that person will be treated as a shareholder of that corporation for tax purposes. See, e.g., Pahl v. Commissioner, 150 F.3d 1124 (9th Cir. 1998),

affg. T.C. Memo. 1996-176; Cabintaxi Corp. v. Commissioner, 63 F.3d 614 (7th Cir. 1995), affg. in part and revg. in part T.C. Memo. 1994-316; Wilson v. Commissioner, 560 F.2d 687 (5th Cir. 1977), affg. T.C. Memo. 1975-92; Anderson v. Commissioner, supra; Yelencsics v. Commissioner, 74 T.C. 1513 (1980); Hook v. Commissioner, 58 T.C. 267 (1972); Beirne v. Commissioner, 52 T.C. 210 (1969); Hoffman v. Commissioner, 47 T.C. 218 (1966), affd. per curiam 391 F.2d 930 (5th Cir. 1968). All of these situations involve an arrangement between parties who had some agreement or understanding regarding their relationship with each other.[12]

However, in none of these cases was the profit of an S corporation not passed through to one of its shareholders because of a poor relationship between the shareholders. We conclude that the beneficial ownership test does not relieve petitioner from passthrough of Green Hills profits.

Second, respondent alleges, and petitioner does not deny, that the payment to petitioner for his Green Hills stock was increased by approximately the amount of petitioner's Federal income tax on a 50-percent distributive share of income from

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[12] See generally Bravenec, Federal Taxation of S Corporations and Shareholders, pp. 7-12 to 7-13 (2d ed. 1988), showing examples of when beneficial ownership test is applied: creditor vs. debtor; nominal shareholder vs. creditor; donor vs. donee; estate vs. heir; entity vs. shareholder; buyer vs. seller; subscriber, redeeming shareholder, or director vs. corporation.

Green Hills.[13] Petitioner received through the arbitrator's award a payment compensating him for his increased Federal income tax liability. Petitioner would receive a windfall if he were not required to pay the tax which was already paid to him as part of the sale of his Green Hills stock. Petitioner makes no persuasive argument that removes this situation from the general definition of a shareholder under section 1.1361-1, Income Tax Regs.

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[13] The purchase price was increased by the distributive share of taxable income multiplied by a fraction the numerator of which is .1367 and the denominator of which is .7070. The .1367/.7070 fraction is about 0.1933. Thus, the purchase price was increased by about 19.33 percent of the total distributive share of income. The top marginal rate of tax on ordinary income for unmarried individuals for 1998, 1999, and 2000, was 39.6 percent. Sec. 1(c). However, the top marginal rate on capital gains income for 1998 was 20 percent, see sec. 1(h)(1)(C), or 18 percent for qualified 5-year gain, see sec. 1(h)(2)(B). Petitioner incurred tax on his distributive share of income at the ordinary income rates, and increased his basis in his Green Hills stock by the same amount. If he had sold his stock in 1998, he would not have incurred tax on his distributive share of income in 1998, 1999, and 2000, but his capital gain would have been higher by the amount of this distributive share of income. Even though petitioner's taxable income would be the same, he incurred more tax than he would have because the capital gains rates are lower than the ordinary income rates. Respondent asserts (and petitioner does not deny) that the arbitrator used a formula to increase the purchase price to compensate petitioner for the difference between Federal income tax imposed on a distributive share of income (for which he would not have been held liable if he had sold the stock on Sept. 24, 1998, but which the parties recognized petitioner was liable or for which he was going to be liable) and that imposed on the change in his capital gain (which would have been higher had the stock been sold in 1998 and petitioner not incurred an additional distributive share of income).

3. Conclusion

We conclude that petitioner must include in income a 50-percent share of the income Green Hills earned in 2000 until October 13, 2000.

To reflect the foregoing and respondent's concession,

Decision will be entered under Rule 155.

APPENDIX B: *Hightower v. Commissioner*, 266 Fed. Appx. 646 (9th Circuit, 2008).

GLENN HIGHTOWER, Petitioner - Appellant, v. COMMISSIONER OF INTERNAL REVENUE, Respondent - Appellee.

No. 06-73838

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

266 Fed. Appx. 646; 2008 U.S. App. LEXIS 3384; 2008-1 U.S. Tax Cas. (CCH) P50,185; 101 A.F.T.R.2d (RIA) 836

February 7, 2008 ** , Submitted, Seattle, Washington

** The panel unanimously finds this case suitable for decision without oral argument. See Fed. R. App. P. 34(a)(2).

February 12, 2008, Filed

NOTICE: PLEASE REFER TO FEDERAL RULES OF APPELLATE PROCEDURE RULE 32.1 GOVERNING THE CITATION TO UNPUBLISHED OPINIONS.

PRIOR HISTORY: [**1]

Appeal from a Decision of the United States Tax Court. Tax Ct. No. 8679-04.

Hightower v. Comm'r, T.C. Memo 2005-274, 2005 Tax Ct. Memo LEXIS 264 (T.C., 2005)

DISPOSITION: AFFIRMED.

COUNSEL: For GLENN HIGHTOWER, Petitioner - Appellant: Glenn Hightower, c/o Aph Technological Consulting, Pasadena, CA.

For COMMISSIONER OF INTERNAL REVENUE, Respondent - Appellee: Lynne L. Glasser, Clerk, U.S. Tax Court, Washington, DC; Donald L. Korb, Acting Chief

Counsel, Internal Revenue Service, Washington, DC; Anthony T. Sheehan, Esq., Eileen J. O'Connor, Esq., DOJ - U.S. DEPARTMENT OF JUSTICE, Tax Division/Appellate Section, Washington, DC.

JUDGES: Before: FISHER, GOULD, and IKUTA, Circuit Judges.

OPINION

[*646] MEMORANDUM *

- - - - - - - - - - - - - - Footnotes - - - - - - - - - - - - - -

* This disposition is not appropriate for publication and is not precedent except as provided by Ninth Circuit Rule 36-3.

- - - - - - - - - - - - End Footnotes- - - - - - - - - - - - -

Before: FISHER, GOULD, and IKUTA, Circuit Judges.

The stock payment Glenn Hightower received for his share of Green Hills was [*647] taxable income in 2000 because it was received without restriction as to its disposition and because Hightower had no fixed legal obligation to restore the funds to any other party. See N. Am. Oil Consol v. Burnet, 286 U.S. 417, 424, 52 S. Ct. 613, 76 L. Ed. 1197, 1932-1 C.B. 293 (1932); Hope v. Comm'r, 471 F.2d 738, 741-42 (3d Cir. 1973). The possibility that the stock transaction could have later been unwound by a California court does not alter the analysis. See Healy v. Comm'r, 345 U.S. 278, 284, 73 S. Ct. 671, 97 L. Ed. 1007, 1953-1 C.B. 68 (1953). Also irrelevant is Hightower's contention that the transaction may have left Green Hills with a negative net worth in violation of state law. See Wentworth v. Comm'r, 510 F.2d 883, 886 (6th Cir. 1975) ("The liability of closely held corporations and their shareholders for federal taxes should not be made to depend upon their compliance with state laws."); James v. United States, 366 U.S. 213, 219-20, 81 S. Ct. 1052, 6 L. Ed. 2d 246, 1961-2 C.B. 9 (1961).

Additionally, Hightower's unilateral intent not to claim and exercise dominion over the funds does not affect his tax liability. See Comm'r v. Alamitos Land Co., 112 F.2d 648, 651 (9th Cir. 1940).

Because the stock payment was taxable income to Hightower in 2000, the interest which accrued on the principal was also taxable income in the year the interest was received.

Hightower was also obliged to report the pass-through distributive share of Green Hills's income allocated to him in 2000. See Treas. Reg. § 1.1361-1(e); Pahl v. Comm'r, 150 F.3d 1124, 1129 (9th Cir. 1998); Anderson v. Comm'r, 164 F.2d 870, 873 (7th Cir. 1947). Even though Hightower's role in Green Hills management may have been restricted, he still retained beneficial ownership of his shares through the October 13, 2000 sale date. Contrary to Hightower's assertions, the arbitration award did not have the effect of divesting him of beneficial ownership of his Green Hills shares in 1998. Rather, it merely gave O'Dowd the financial benefit of the bargain retroactively once the sale took place in 2000.

AFFIRMED.

APPENDIX C: *Hightower v. Commissioner*, Order Denying Rehearing En Banc.

FILED

Apr 28, 2008

MOLLY C. DWYER, CLERK
U.S. COURT OF APPEALS

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

GLENN HIGHTOWER Petitioner – Appellant, v. COMMISSIONER OF INTERNAL REVENUE, Respondent – Appellee.	No. 06-73838 Tax Ct. No. 8679-04 ORDER

Before: FISHER, GOULD, and IKUTA, Circuit Judges.

The panel has voted to deny Petitioner's Petition for Rehearing En Banc.

The full court has been advised of the Petition for Rehearing En Banc and no Judge has requested a vote to rehear the matter en banc. Fed. R. App. P.35.

The Petition for Rehearing En Banc is DENIED.

APPENDIX D: Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1998* (JCS-6-98), November 24, 1998, pp. 56-59.

TITLE III. TAXPAYER PROTECTION AND RIGHTS

A. Burden of Proof (sec. 3001 of the Act and new sec. 7491 of the Code)

Present and Prior Law

Under present law, a rebuttable presumption exists that the Commissioner's determination of tax liability is correct.[33] "This presumption in favor of the Commissioner is a procedural device that requires the plaintiff to go forward with prima facie evidence to support a finding contrary to the Commissioner's determination. Once this procedural burden is satisfied, the taxpayer must still carry the ultimate burden of proof or persuasion on the merits. Thus, the plaintiff not only has the burden of proof of establishing that the Commissioner's determination was incorrect, but also of establishing the merit of its claims by a preponderance of the evidence."[34]

The general rebuttable presumption that the Commissioner's determination of tax liability is correct is a fundamental element of the structure of the Internal Revenue Code. Although this presumption is judicially based, rather than legislatively based, there is considerable evidence that the presumption has been repeatedly considered and approved by the Congress. This is the case because the Internal Revenue Code contains a number of civil provisions that explicitly place the

burden of proof on the Commissioner in specifically designated circumstances.

Under prior law, there was no statutory provision that generally provided burden of proof rules.

Reasons for Change

The Congress was concerned that individual and small business taxpayers frequently are at a disadvantage when forced to litigate with the Internal Revenue Service. The Congress believed that the prior-law burden of proof rules contributed to that disadvantage. The Congress believed that, all other things being equal, facts asserted by individual and small business taxpayers who cooperate with the IRS and satisfy relevant recordkeeping and substantiation requirements should be accepted. The Congress believed that shifting the burden of proof to the Secretary in such circumstances would create a better balance between the IRS and such taxpayers, without encouraging tax avoidance. The Congress believed that it is inappropriate for the IRS to rely solely on statistical information on unrelated taxpayers to reconstruct unreported income of an individual taxpayer. The Congress [57] also believed that, in a court proceeding, the IRS should not be able to rest on its presumption of correctness if it does not provide any evidence whatsoever relating to penalties.

Explanation of Provision

The Act provides that the Secretary has the burden of proof in any court proceeding with respect to a factual issue if the taxpayer introduces credible evidence with respect to the factual issue relevant to ascertaining the taxpayer's specified tax liability.

The provision applies to income,[35] estate, gift, and generation-skipping transfer taxes. Four conditions apply. First, the taxpayer must comply with the requirements of the Internal Revenue Code and the regulations issued thereunder to substantiate any item (as under prior law). Second, the taxpayer must maintain records required by the Code and regulations (as under prior law). Third, the taxpayer must cooperate with reasonable requests by the Secretary for meetings, interviews, witnesses, information, and documents (including providing, within a reasonable period of time, access to and inspection of witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the Secretary). Cooperation also includes providing reasonable assistance to the Secretary in obtaining access to and inspection of witnesses, information, or documents not within the control of the taxpayer (including any witnesses, information, or documents located in foreign countries[36]). A necessary element of cooperating with the Secretary is that the taxpayer must exhaust his or her administrative remedies (including any appeal rights provided by the IRS). The taxpayer is not required to agree to extend the statute of limitations to be considered to have cooperated with the Secretary. Cooperation also means that the taxpayer must establish the applicability of any asserted privilege. Fourth, taxpayers other than individuals or estates must meet the net worth limitations that apply for awarding attorney's fees (accordingly, no net worth limitation would be applicable to individuals). Corporations, trusts,[37] and partnerships whose net worth exceeds $7 million are not eligible for the benefits of the provision. The taxpayer has

the burden of proving that it meets each of these conditions, because they are necessary prerequisites to establishing that the burden of proof is on the Secretary.

The burden will shift to the Secretary under this provision only if the taxpayer first introduces credible evidence with respect to a factual issue relevant to ascertaining the taxpayer's income tax liability. Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness). A taxpayer has not produced credible evidence for these purposes if [58] the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that it is worthy of belief. If after evidence from both sides, the court believes that the evidence is equally balanced, the court shall find that the Secretary has not sustained his burden of proof.

Nothing in the provision shall be construed to override any requirement under the Code or regulations to substantiate any item. Accordingly, taxpayers must meet applicable substantiation requirements, whether generally imposed[38] or imposed with respect to specific items, such as charitable contributions[39] or meals, entertainment, travel, and certain other expenses.[40] Substantiation requirements include any requirement of the Code or regulations that the taxpayer establish an item to the satisfaction of the Secretary.[41] Taxpayers who

fail to substantiate any item in accordance with the legal requirement of substantiation will not have satisfied the legal conditions that are prerequisite to claiming the item on the taxpayer's tax return and will accordingly be unable to avail themselves of this provision regarding the burden of proof. Thus, if a taxpayer required to substantiate an item fails to do so in the manner required (or destroys the substantiation), this burden of proof provision is inapplicable.[42]

In the case of an individual taxpayer, the Secretary has the burden of proof in any court proceeding with respect to any item of income which was reconstructed by the Secretary solely through the use of statistical information on unrelated taxpayers.

Further, the provision provides that, in any court proceeding, the Secretary must initially come forward with evidence that it is appropriate to apply a particular penalty to the taxpayer before the court can impose the penalty. This provision is not intended to require the Secretary to introduce evidence of elements such as reasonable cause or substantial authority. Rather, the Secretary must come forward initially with evidence regarding the appropriateness of applying a particular penalty to the taxpayer; if the taxpayer believes that, because of reasonable cause, substantial authority, or a similar provision, it is inappropriate to impose the penalty, it is the taxpayer's responsibility (and not the Secretary's obligation) to raise those issues.

Effective Date

The provision applies to court proceedings arising in connection with examinations commencing after the date of enactment (after July 22, 1998). In any case in which there is no examination, the [59] provision applies to court proceedings arising in connection with taxable periods or events beginning or occurring after the date of enactment. An audit is not the only event that would be considered an examination for purposes of this provision. For example, the matching of an information return against amounts reported on a tax return is intended to be an examination for purposes of this provision. Similarly, the review of a claim for refund prior to issuing that refund is also intended to be an examination for purposes of this provision.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million in 1998, $231 million in 1999, $256 million in 2000, $269 million in 2001, $278 million in 2002, $297 million in 2003, $311 million in 2004, $327 million in 2005, $344 million in 2006, and $360 million in 2007.

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[33] *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

[34] *Danville Plywood Corp. v. U.S.*, U.S. Cl. Ct., 63 AFTR 2d 89–1036, 1043 (1989).

[35] For this purpose, self-employment taxes are treated as income taxes.

[36] Cooperation also includes providing English translations, as reasonably requested by the Secretary.

[37] An exception to this rule removes the net worth limitation from certain revocable trusts for the same period of time that the trust would have been treated as part of the estate had the trust made the election under section 645 to be treated as part of the estate. This reflects the technical correction enacted in section 4002(b) of the Tax and Trade Relief Extension Act of 1998, described in Part Three of this publication.

[38] See e.g., sec. 6001 and Treas. Reg. sec. 1.6001–1 requiring every person liable for any tax imposed by this Title to keep such records as the Secretary may from time to time prescribe, and secs. 6038 and 6038A requiring United States persons to furnish certain information the Secretary may prescribe with respect to foreign businesses controlled by the U.S. person.

[39] Sec. 170(a)(1) and (f)(8) and Treas. Reg. sec. 1.170A–13.

[40] See e.g., Sec. 274(d) and Treas. Reg. sec. 1.274(d)–1, 1.274–5T, and 1.274–5A.

[41] For example, sec. 905(b) of the Code provides that foreign tax credits shall be allowed only if the taxpayer establishes to the satisfaction of the Secretary all information necessary for the verification and computation of the credit. Instructions for meeting that requirement are set forth in Treas. Reg. sec. 1.905–2.

[42] If, however, the taxpayer can demonstrate that he had maintained the required substantiation but that it was destroyed or lost through no fault of the taxpayer, such as by fire or flood, existing tax rules regarding reconstruction of those records would continue to apply.